



**The South Australian Council of Social Service (SACOSS)
Submission to the ESCOSA Review of Retail Price Setting Methodology**

December 2009

The South Australian Council of Social Service (SACOSS)
Submission to the ESCOSA Review of Retail Price Setting Methodology
December 2009

ISBN 978-0-908293-72-8

First published in December 2009 by the
South Australian Council of Social Service

47 King William Road
Unley, SA, 5061 Australia
Ph (08) 8305 4222
Fax (08) 8272 9500
Email: sacoss@sacoss.org.au
Website: www.sacoss.org.au

Written by Andrew Nance and Tom Stead, South Australian Council of Social Service.

© South Australian Council of Social Service, 2009

This publication is copyright. Apart from fair dealing for the purpose of private study, research, criticism or review, as permitted under the Copyright Act, no part may be reproduced by any process without written permission. Enquiries should be addressed to the Communications Officer, South Australian Council of Social Service.

Contents

Scope of interest.....	1
Introduction	2
The role of the Standing Contract.....	3
The Price Stack – the Building Blocks.....	7
The Consumer Experience	9
References	13

Scope of interest

The South Australian Council of Social Service (SACOSS) is the peak body for social services in South Australia, and is an independent non-government organisation with a proud sixty year history of advocating for disadvantaged and vulnerable South Australians. SACOSS is a not-for-profit independent organisation whose members represent a wide range of interests in social welfare, health and community services. SACOSS is part of a national network assisting low income and disadvantaged people, and shares with its members the vision of *justice, opportunity and shared wealth for all South Australians*.

In its role as a peak body for community services in South Australia SACOSS covers a broad range of policy areas including the impacts of disadvantage on the most vulnerable South Australians. In recent years SACOSS has led or participated in debate and advocacy in the areas of consumer credit, electricity and gas, telecommunications, financial counselling, payday lenders, food security and gambling.

SACOSS welcomes the opportunity to provide a submission to the Essential Services Commission of SA (ESCOSA) Review of Retail Price Setting Methodology. This submission is part of the Consumer Advocacy Panel-funded National Energy Market Reform Advocacy Capacity Building Project – South Australia. SACOSS' interest in retail pricing is based on the needs of vulnerable consumers and the implications of any change to the methodology used to set regulated retail pricing in SA. It is SACOSS' firm belief that all South Australian electricity consumers have an interest in a robust regulatory framework for retail price setting, and that any changes to the methodology for setting retail pricing need to be viewed through the lens of the most disadvantaged in society.

This submission is supported by the following organisations:

- Aboriginal Prisoner and Offender Support Service (APOSS)
- Multicultural Communities Council of SA (MCCSA)

Introduction

SACOSS welcomes ESCOSA's review of retail price setting methodology for the simple reason that the means by which retail prices are set affects all energy consumers. The Discussion Paper released by ESCOSA essentially lays out two main options for future price regulation: the current 'building block' approach; and an index-based approach. The paper asks the question as to whether or not the previous approaches by ESCOSA to setting the electricity and gas standing contract retail price path are appropriate to follow for the next round of reviews (2010 for electricity, 2011 for gas). In its paper, ESCOSA indicates a preference to stick to the existing methodology unless a good alternative can be found and then offers up an option of considering some cost index-based comparison approach.

SACOSS has considered the contents of the Discussion Paper and the options presented, and has prepared the following response based on reflection of our basic principles for Essential Services:

All South Australians are entitled to reasonable access to sufficient quantities of essential services to maintain a healthy life.

Reasonable access is to be considered in terms of unit prices, any other fees and charges as well as the terms and conditions of access imposed from time to time by private operators or government regulators.

From a SACOSS perspective, the relevant questions stem from the role of the standing contract. The price setting essentially sets the 'price to beat' for market based contract offers and also defines arrangements for a form of 'universal access' in relation to the terms and conditions of contract – the non-price aspects. On this basis, the key question for SACOSS in response to this paper is which of the options presented is likely to lead to a more affordable 'ceiling price'?

The answer is not immediately obvious but other questions can help. Is either option more or less open to gaming by the industry? Is one option more transparent? Is one option more or less 'volatile' and therefore likely to lead to more stable pricing and therefore easier budgeting? The building block approach certainly offers a level of transparency that is of benefit to small consumers. The process of having ESCOSA analyse each element in itself offers a degree of transparency and scrutiny that offers some reassurance to small consumers that the prices they pay are reasonable.

At this point in time, SACOSS would be reluctant to move away from such detailed scrutiny without a much stronger case for doing so. However, there are also some possibilities for employing a hybridised approach – one that utilises both a building block and an indexing approach. SACOSS recognises and supports the UnitingCare Wesley submission to this review and the two organisations will be working together on a hybridised model. While this idea has not been explored in great detail, this submission will lay out the framework for such a hybridised approach, and the main principle on which it is based: that all South Australians are entitled to reasonable access to sufficient quantities of essential services to maintain a healthy life. SACOSS firmly believes that the main element of such a model would be the extension of the first pricing tier to recognise the basic needs of the community in terms of a minimum volume of energy required for a healthy life. By providing this first extended tier at a low price, the requirement would be to raise the prices of subsequent tiers.

The role of the Standing Contract

As mentioned above, in its Discussion Paper (ESCOSA, 2009b), ESCOSA exhibits a view that it would prefer to see its existing building block approach to retail price setting retained. There is good reason to take this view, mainly in that it assists in transparently setting the Standing Contract prices, which are effectively the 'ceiling price' for energy consumers. It also allows certainty for consumers who do not wish to participate in the competitive market.

According to the paper (with emphasis added to the salient points):

*... effective competition takes time to evolve, and transitional regulation of retail prices was imposed by the South Australian Government to **protect vulnerable customers** and ensure small consumers had **access to a basic standard of service at a reasonable price**. (p17)*

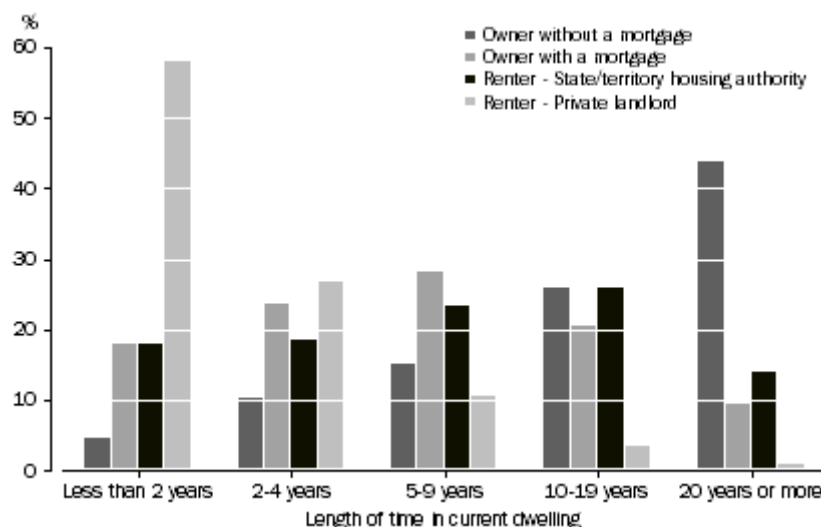
*... it is the Commission's view that the purpose of the standing contract price, for the regulatory period 2011 to 2013 for both electricity and gas, is to **provide price protection** for those South Australian customers who are, for whatever reason, unable or unwilling to participate in the energy retail market; while at the same time allowing for price flexibility to enable appropriate responses to significant changes in input costs. This approach will permit energy retailers to compete in the market and deliver to consumers the benefits of competition while at the same time protecting those who pay the standing contract price. (p29)*

Based on the view that the purpose of the Standing Contract price is to provide price protection for those unable or unwilling to participate in the energy retail market, it would be useful to understand the characteristics of the consumers who remain on the Standing Contract. Unfortunately little is published about these consumers other than their rough numbers and the proportion of residential versus small business customers in their number.

Intuitively, it seems likely that those remaining on the Standing Contract have not moved home since the introduction of FRC in 2003. This is because the practice appears to be that when a customer moves home, the Standing Contract is not explicitly marketed, the preference being to highlight the benefits of Market Contracts. It is therefore likely that this cohort represents a significant proportion of the aged and low-income population.

The recent release from the Australian Bureau of Statistics of their first issue Housing Mobility and Conditions (ABS, 2009) includes the following chart (Figure 1) of housing mobility:

Figure 1: Housing Mobility



The ABS report also states:

The length of time people have spent in their current dwelling is strongly related to their age and their tenure and landlord type. In 2007-08, 85% of reference persons who were owners without a mortgage had spent more than 5 years in their current dwelling and 44% had spent more than 20 years. For owners with a mortgage, 58% of reference persons had spent more than 5 years in their current dwelling and 9% had spent more than 20 years.

Most (64%) household reference persons who rented from state or territory housing authorities had spent more than 5 years in their current dwelling and 14% had spent more than 20 years. Only 15% of private renters had spent more than 5 years in their current dwelling, with 58% having spent less than 2 years. This is, in part, a reflection of the generally younger age profile of private renters, who may move for study, employment or relationship reasons.

Acknowledging that these are national figures until the end of the 2007-08 Financial year, the latter three time frames in the chart can be said to be indicative of the profile of those householders who have been in the same dwelling since prior to the introduction of FRC. Based on the above and anecdotal evidence it is highly likely that the consumers of greatest interest to SACOSS are well represented within those that remain on the Standing Contract.

In recent times, it appears that prices set for the Standing Contract are proving to be a good estimate of what the market considers 'competitive'. ESCOSA's 2008-09 Annual Performance Report (ESCOSA, 2009a) provides some instructive commentary around the standing contract:

2.6.2.7 Reduction in active marketing to small customers

During the year there was a continuation of the trend, first observed in the latter half of 2006/07, for energy retailers' to limit the extent to which they undertook marketing activities in this State. Some retailers ceased actively marketing to new customers, while continuing to service existing customers, while others ceased marketing to new customers and advised existing customers that they would need to find a new retailer on the expiry of their current contract. In effect, consumers were offered fewer choices in 2008/09 than has been the case in the past.

The tailing off in marketing activity coincides with:

- the impact of the global financial crisis on the general availability of funds for business investment and expansion;
- reduced availability of longer term, price certain generator contracts; and

- wholesale market uncertainties arising from the proposed carbon pollution reduction scheme.

2.6.2.8 Changing role of the standing contract

This year saw the continuation of the trend which began to emerge last year, wherein an increasing number of electricity retail contracts are now priced above the standing contract price. Contracts priced at a premium to the standing contract tend to be “green” products. Figure 2.11 shows that the standing contract price now sits towards the bottom end of the range of all contract prices available to customers. This is a notable change from earlier years when the standing contract was effectively a “ceiling” price and almost all other retail offers were set at either the same level or a discount to that price.

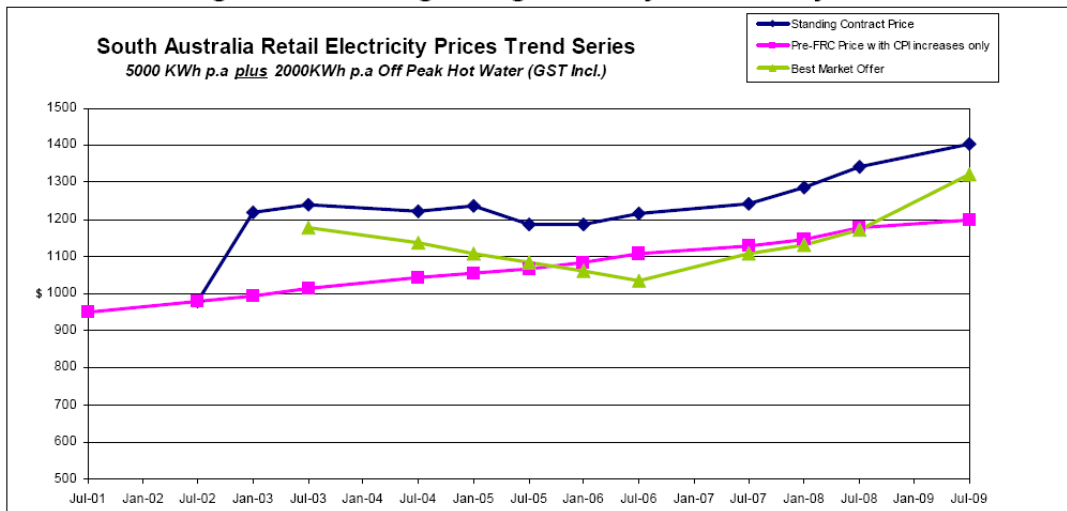
Further developments include a reduction in number of retail contracts offering a “discount” below the level of the standing contract price, as well as the move by some retailers away from offering contracts on the basis of discount against the standing contract price and towards the use of other pricing incentives.

In relation to the reduction in the numbers of contracts with discounts against the standing contract price, this may be a response to the tighter market conditions described above and the differing cost pressures and wholesale contract positions of each retailer.

This is supported by the following chart from the Minister for Energy's Energy Consumers Council Annual Report 2008-9 (ECC, 2009) (see Figure 2, figure 4-1, page 13 in original):

The Standing Contract Price line illustrates the price increase of 23.7 per cent that ESCOSA approved on 1 January 2003. It then shows the cost changes since the peak of July 2003, reflecting subsequent price determinations for retail and distribution made by ESCOSA. The Best Market Offer line illustrates the cheapest market contract that existed at the relevant dates for the average usage customers described above, as determined by the ESCOSA Estimator price comparison service. The Pre-FRC Price with CPI increases only line illustrates the per annum price that the electricity customer would be facing if the tariffs that existed in January 2001 had continued into the future, only being adjusted for CPI.

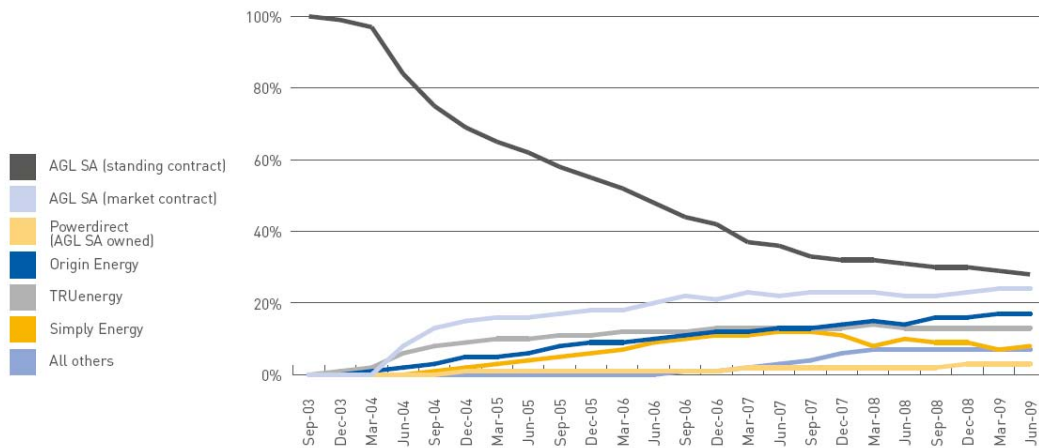
Figure 2: ECC Price Trend Analysis
Figure 4-1: Average Usage Bill July 2001 to July 2009



The chart illustrates the convergence of market prices with the standing contract price in recent times. This is also consistent with the declining rate of movement away from the standing contract illustrated in the following ESCOSA Chart (Figure 3):

Figure 3: Market Share Trends

Figure 2.7 Residential electricity market share trends (% of residential customer base)



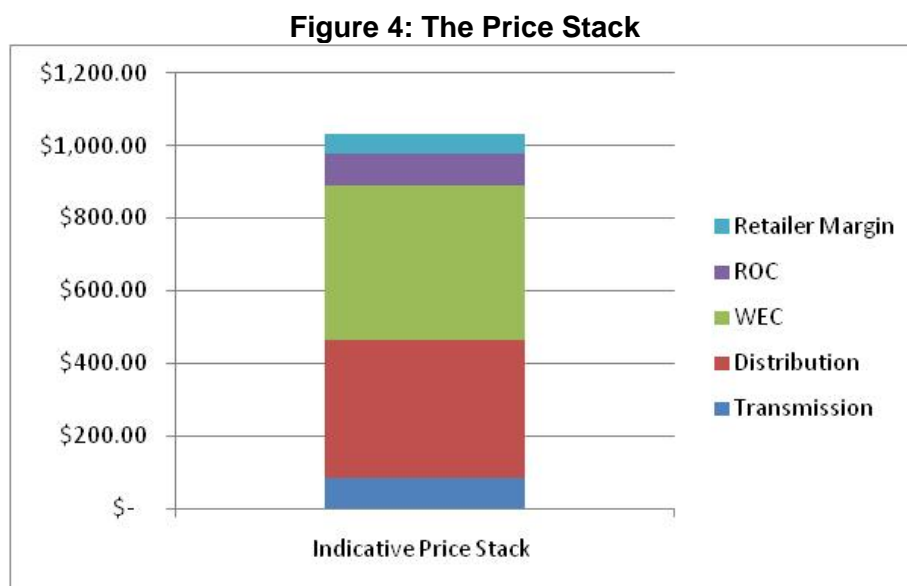
While it is understood that climate change policies may represent a level of uncertainty for energy retailers into the future, it is hoped that ESCOSA recognises the importance of the Standing Contract for many low income and disadvantaged South Australians. It is a SACOSS view that the Standing Contract customers, although they now represent only around 28% of the residential electricity market, are not to be used as ‘guinea pigs’ through an excessive headroom component as suggested by the AEMC in their Review of Energy Market Frameworks in light of Climate Change Policies (AEMC, 2009)¹. The following section further illustrates SACOSS’ concerns and views in this regard.

¹ See, for example, Chapter 5 p62: “Where prices are set by a regulator over a longer timeframe, ensuring competitive “headroom” in the initial price determination is vital.”

The Price Stack – the Building Blocks²

The current approach to retail price setting methodology is known as the ‘building block’ approach. This approach involves separating the different costs associated with retail energy and only displayed on a customer’s bill as a total amount. This method allows ESCOSA to assess each component of the total ‘price stack’ and reach a decision on the total that a consumer will have to pay under the Standing Contract ‘ceiling price’.

Figure 4 below represents the indicative ‘price stack’ based on the 2007 Electricity Retail Price Determination, calculated on consumption of 5000kWh per annum.



Pre-GST, these elements are in the following approximate proportions:

<u>Transmission</u>	8%
<u>Distribution</u>	37% (ie network total = 45%)
<u>Wholesale Energy</u>	41%
<u>Retail Operating Costs</u>	9%
<u>Retail Margin</u>	5%

Based on the key reasons for considering a change in methodology – to deal with the uncertain impacts of a carbon price and renewable energy obligations – it is arguable that it is only the Wholesale Energy Cost (WEC) component that might be materially different. Historic assessments of Retail Operating Costs and Margin (Profit) should not be materially influenced by these changed market conditions.

The WEC component on the other hand is the area of most uncertainty and, from a retailer’s perspective, regulatory risk. It is important to remember that this component is in itself made up of two notional components – the average wholesale pool price and the cost of risk management –

² SACOSS notes that UnitingCare Wesley Adelaide, in its submission, has more detailed descriptions of the building block and index approaches.

both of which are going to be influenced by the introduction of a carbon price and expanded renewable energy obligations.

It is a SACOSS opinion that, at least for the next regulatory period, that all small consumers, those on the standing contract and those not, would benefit from a detailed building block approach to understanding the WEC component. It is also recognised that an estimation 'before the fact' is going to be more difficult even than it has been in the past. Because of this (albeit limited) uncertainty, SACOSS holds the view that a hybridised approach to climate change policies – that retains the building block approach in general, but provides some headroom through indexation for uncertainties in the WEC component – should remain a possibility for consideration by ESCOSA.

The Consumer Experience

To most consumers, all of the above is somewhat academic. The important part for them is the bottom line on the bill they receive each quarter and how it fits into to their financial circumstances. SACOSS and UnitingCare Wesley Adelaide have revisited the fundamental question posed by our constituents, *“How can we make energy more affordable for the most vulnerable?”*

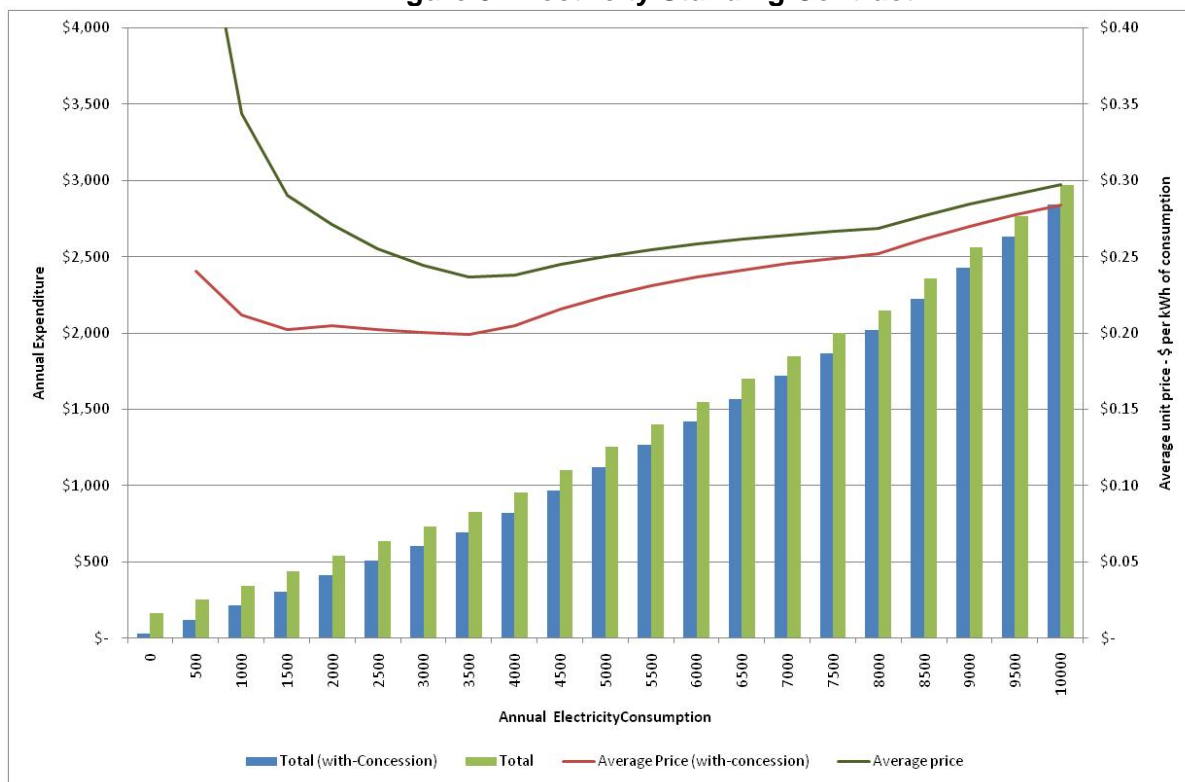
For those on low and fixed incomes, there are three basic approaches to affordability:

1. Managing demand – ensuring the most efficient use of energy to meet the health and basic needs of householders
2. Tariff structures (including the removal of GST)
3. Community Service Obligations (CSOs) and Concessions

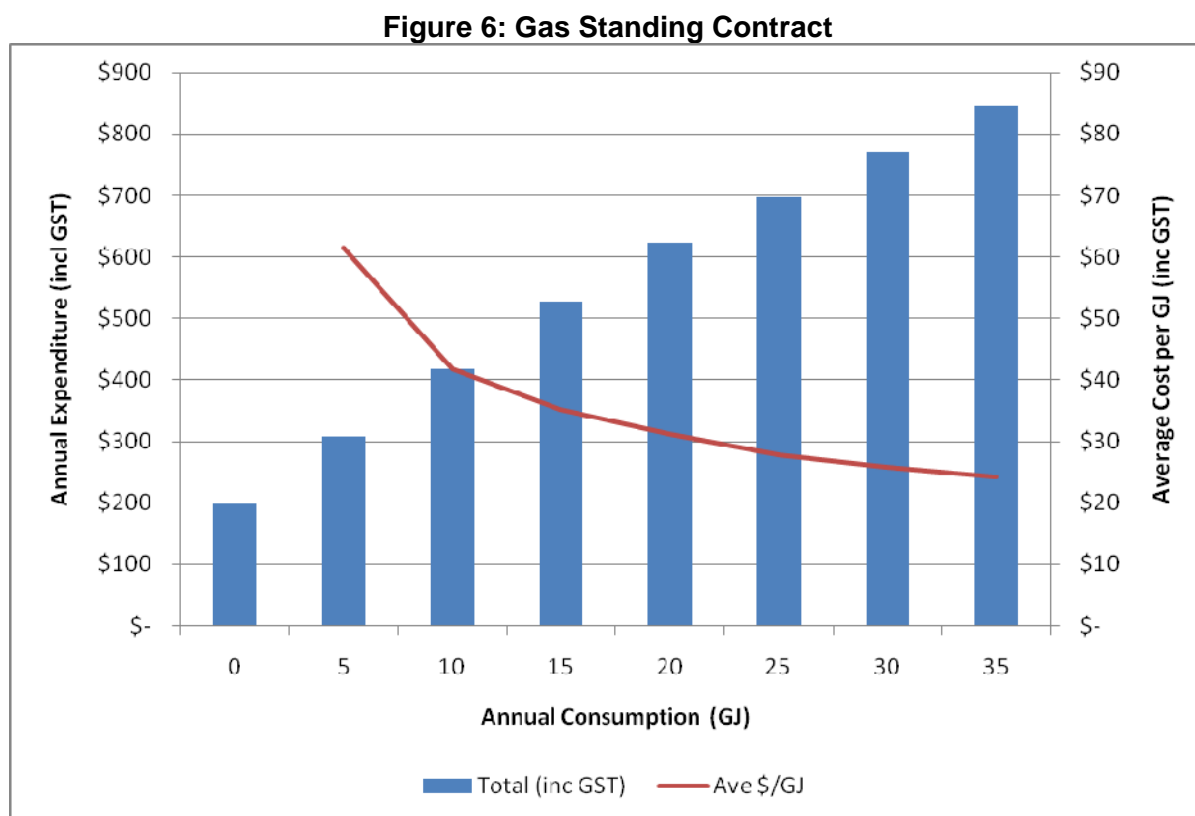
Of direct relevance to the current Review and the role of the standing contract, the tariff structures warrant further discussion.

From the consumer’s experience these contracts can be illustrated with cost versus consumption charts. The standing electricity contracts (not including off-peak hot water) look like this (Figure 5):

Figure 5: Electricity Standing Contract



And the standing gas contract looks like this (Figure 6):



Both cost versus consumption charts illustrate the effect of a significant fixed 'supply' or service to property charge and a block tariff – inclining in the case of electricity and declining in the case of gas.

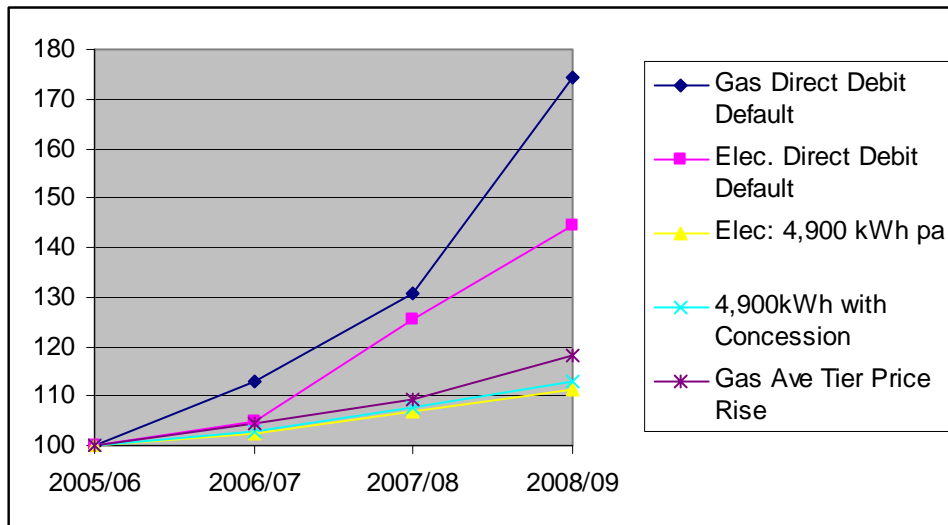
For the majority of the most vulnerable customers, these costs are moderated by the state's energy concession. The concession goes some way to paying the service to property charges. For 2008-9 the service to property charges under the standing contracts are (incl GST)

<u>Electricity</u>	<u>\$160.83</u>
<u>Gas</u>	<u>\$197.43</u>
<u>Dual Fuel</u>	<u>\$358.25</u>
<u>Concession</u>	<u>\$132 (effective; \$120 applied to the pre GST total)</u>

The question is not whether these charges are reasonable from a market perspective, but whether they are affordable from a consumer's perspective.

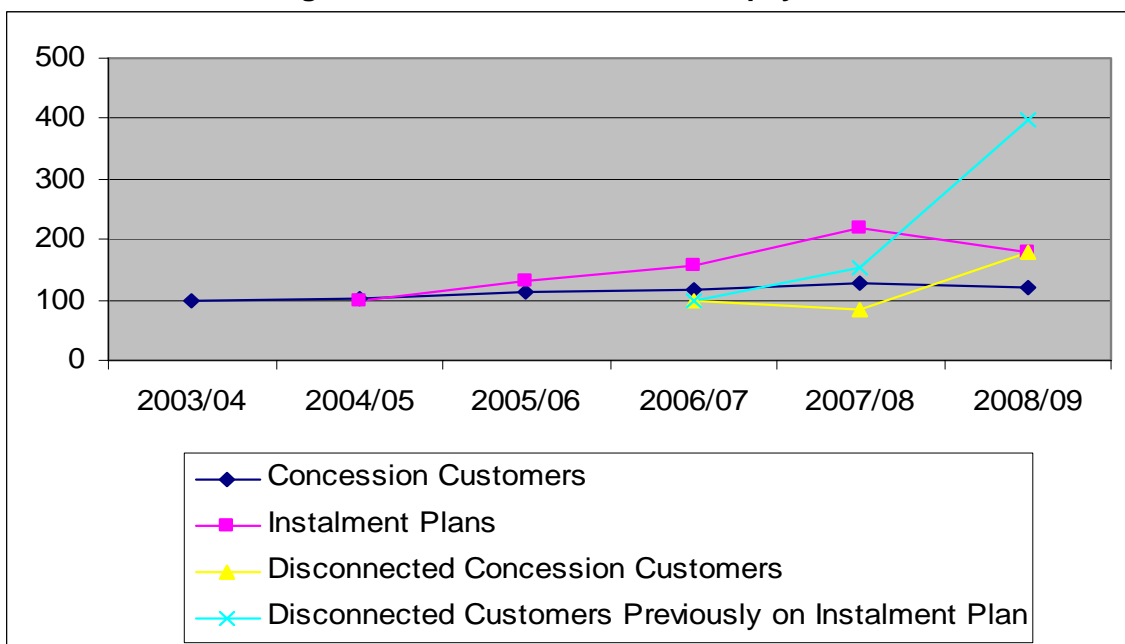
Recent figures from the ESCOSA Annual Performance Report for 2008-09 show that current customer assistance measures are failing, and it can be argued that this is in some part due to the rising fixed costs mentioned above. The recent figures show, for example, that as prices have risen, the numbers of direct debit defaults for both electricity and gas customers have risen, as shown in Figure 7 below.

Figure 7: Direct Debit Defaults



Additional figures show that while the number of concession customers for electricity dropped in the last financial year, the number of these customers disconnected for non-payment rose. The rate of instalment plan customers and disconnection for non-payment for these customers tells a similar story. Figure 8 below shows these figures as indexed. It shows that while there was a slight drop in the number of customers on concessions and instalment plans, the number of these customers disconnected for non-payment rose significantly – roughly quadrupling for instalment plans and doubling for concessions.

Figure 8: Disconnections for Non-payment



What is clear from these and other figures is that customers are struggling to meet energy payments under the current system. However SACOSS remains confident that the building block approach remains the most transparent method for regulating prices in the absence of a clearly defined index or hybridised approach.

Summary

Given what can be deduced from figures mentioned in this submission – that is, the number of customers remaining on the Standing Contract and home mobility statistics – SACOSS supports the views of UnitingCare Wesley and others in that in the absence of a definitive argument for an index approach to retail price setting methodology, the building block approach should be maintained. However SACOSS and UnitingCare Wesley Adelaide intend to progress a further analysis of the tariff structures and demand management and energy efficiency initiatives that might permit a greater level of affordability for the state's most vulnerable energy consumers. The first and primary element of this model would be the extension of the first pricing tier to include enough energy for a healthy life at an affordable price, with the additional retail and network costs being recovered primarily from higher-end users on subsequent tiers.

It is anticipated that this analysis will lead to a formal proposal for a package of measures to assist the vulnerable. This package would include:

- Targeting of energy efficiency and demand management programs and, especially, their implementation to the most vulnerable – with the intention of bringing consumption into a target range;
- Tariff structures that ensure consumption within this range is affordable;
- Targeted concessions to aid those who for legitimate reasons are unable to bring consumption to within the target range; and
- Other measures as the package is developed.

As the package is developed, SACOSS welcomes further consultation with ESCOSA on this important issue.

References

ABS (2009), 'Housing Mobility and Conditions', 2007–08, Cat No. 4130.0.55.002 First Issue Released 20/11/2009. Available from: www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/4130.0.55.002MainFeatures22007-08?

AEMC (2009), 'Review of Energy Market Frameworks in light of Climate Change Policies: Final Report', Australian Energy Market Commission, October 2009. Available from: www.aemc.gov.au/Market-Reviews/Completed/Review-of-Energy-Market-Frameworks-in-light-of-Climate-Change-Policies.html

ECC (2009), 'Energy Consumers' Council Annual Report, 2008-09', Energy Consumers' Council, November 2009. Available from: www.dtei.sa.gov.au/_data/assets/pdf_file/0005/43691/FINAL_ECC_ANNUAL_REPORT_2008-2009.pdf

ESCOSA (2009a), '09/09 Annual Performance Report: South Australian Energy Supply Industry', Essential Services Commission of South Australia, November 2009.

ESCOSA (2009b), 'Review of Energy Retail Price Setting Methodology Discussion Paper', Essential Services Commission of South Australia, October 2009.